



F U N D A Ç Ã O
GETULIO VARGAS

EPGE

Escola de Pós-Graduação
em Economia

Ensaio Econômico

Escola de

Pós-Graduação

em Economia

da Fundação

Getúlio Vargas

Nº 456

ISSN 0104-8910

A Contractive Method for Computing the Stationary Solution of the Euler Equation

Humberto Luiz Ataíde Moreira, Wilfredo L. Maldonado

Setembro de 2002

URL: <http://hdl.handle.net/10438/512>

Os artigos publicados são de inteira responsabilidade de seus autores. As opiniões neles emitidas não exprimem, necessariamente, o ponto de vista da Fundação Getulio Vargas.

ESCOLA DE PÓS-GRADUAÇÃO EM ECONOMIA

Diretor Geral: Renato Fragelli Cardoso

Diretor de Ensino: Luis Henrique Bertolino Braidó

Diretor de Pesquisa: João Victor Issler

Diretor de Publicações Científicas: Ricardo de Oliveira Cavalcanti

Luiz Ataíde Moreira, Humberto

A Contractive Method for Computing the Stationary
Solution of the Euler Equation/ Humberto Luiz Ataíde Moreira,
Wilfredo L. Maldonado - Rio de Janeiro : FGV,EPGE, 2010
(Ensaíes Econômicos; 456)

Inclui bibliografia.

CDD-330

A CONTRACTIVE METHOD FOR COMPUTING THE STATIONARY SOLUTION OF THE EULER EQUATION*

¹WILFREDO L. MALDONADO †

²HUMBERTO MOREIRA ‡

¹Department of Economics
Universidade Federal Fluminense
Rua Tiradentes 17, Ingá, Niterói
CEP 24210-510, RJ, Brasil
Email: willy@impa.br

² EPGE/FGV
Praia de Botafogo, 190
CEP 22253-900, RJ, Brasil
E-mail: humberto@fgv.br

ABSTRACT. A contractive method for computing stationary solutions of intertemporal equilibrium models is provided. The method is implemented using a contraction mapping derived from the first-order conditions. The deterministic dynamic programming problem is used to illustrate the method. Some numerical examples are performed.

1. Introduction

In intertemporal economic models one of the main difficulties is to find accurate estimatives of the stationary solutions. For instance, in dynamic programming models the traditional method is based on the Bellman approach. This consists in estimating the corresponding value function using a contraction mapping (see Stokey and Lucas with Prescott (1989)) and then computing the policy function from the approximated value function.

Taylor and Uhlig (1990) described some numerical methods based on the Bellman iterations (i.e., *Value-Function Grid* and *Quadrature Value-Function Grid* methods) and Santos and Vigo-Aguiar (1998) and Maldonado and Svaiter (2001) provided an estimation error for the approximate policy. However, Bellman's method has two main disadvantages: it is only useful when the model can be expressed as a representative agent model and, besides that, the speed of convergence is slow. On the other hand, numerical methods based on the

* This paper was presented at the 8th International Conference of the Society for Computational Economics in June, 2002. The authors gratefully acknowledge the comments of K. Judd. We also thank Caio Ibsen and David Moura for helping us with the numerical implementation.

† I would like to thank the CNPq of Brazil for the financial support 300059/990(RE).

‡ This research was supported by CNPq of Brazil.

solution of the Euler equation have been more efficient in the two aspects above: they can be used even when there is no representative agent and they are faster when an adequate approximation scheme is performed (see Judd (1998)).

The backward iteration algorithm, based on the Euler equation, provides a sequence of functions which converges pointwisely to the stationary solution. To implement this algorithm, Baxter *et.al* (1990) used a discretized version of the original problem. And using Santos and Vigo-Aguiar (2000) result, we know that the distance between the solution of the discretized problem and the solution of the original one is of order one in the grid mesh. Coleman (1990, 1991) used a similar approach, however the discretization is not necessary since linear interpolations are performed. Other numerical methods based on Euler equations are the projection method (Judd (1992)) and the parameterizing-expectations method (Marcet (1988) and Marcet and Lorenzoni (1998)).

The goal of this paper is also to provide a numerical method based on Euler equations to compute accurate estimatives of stationary solutions. For this, we define a contraction mapping which has the stationary solution as its fixed point. Moreover, the metric that we use is the C^1 uniform convergence. An important feature of our method is that it also provides an algorithm that compute the stationary solution for each state variable value. That is, we do not need to make a grid of the state variables for solving the Euler equation.

The convergence of our method requires a condition which is slightly stronger than the determinacy of the steady state condition. For the dynamic programming problem this amounts to the dominant diagonal condition. Some numerical examples are provided where this condition is satisfied for a realistic parameter set of the models.

The paper is divided as follows. In section 2 we present the deterministic model and its main hypotheses. In section 3 our contractive method based on the Euler-equation is presented. Finally, section 4 implements the algorithm derived from this method and gives some applications. All proofs are given in the appendix.

2. Basic Framework

The intertemporal equilibrium models that we are going to deal with are described by the following elements: $X \subset \mathbb{R}^n$ is the state space, $D \subset X \times X \times X$ represents the intertemporal feasibility set and $E : D \rightarrow \mathbb{R}^n$ is the function whose zeros define the temporary equilibria. We will assume that E is a twice continuously differentiable such that E_2 is negative definite on the interior of D .¹

Let $|\cdot|$ be one of the equivalent norms of \mathbb{R}^n . The associated norm for the real square matrices space of order n (\mathcal{M}_n) will be $\|\cdot\|$.² Finally, let $B_r(x) = \{y \in \mathbb{R}^n ; |y - x| < r\}$.

An equilibrium path from $x_0 \in X$ is a sequence $(x_t)_{t \geq 0}$ such that

$$E(x_{t-1}, x_t, x_{t+1}) = 0$$

and a stationary solution for (X, D, E) is a function $g : X \rightarrow X$ such that:

$$E(x, g(x), g^2(x)) = 0$$

¹Since E is a function of $(x_1, x_2, x_3) \in D$, E_j is the vector of partial derivatives of E with respect to x_j .

² $\|X\| = \sup_{\{x \in \mathbb{R}^n ; |x|=1\}} |Xx|$, $X \in \mathcal{M}_n$.

for all $x \in X$.

We say that $\bar{x} \in \mathfrak{R}^n$ is a *steady state* if $g(\bar{x}) = \bar{x}$. We will make the following:

Assumption D. *There exists an interior steady state \bar{x} and α such that³*

- (i) $\|(E_2)^{-1}E_1\| + \|(E_2)^{-1}E_3\| < \alpha < 1$
- (ii) $\|(E_2)^{-1}E_3\| < 1/2$

Remark: The condition for the existence of a locally unique stationary equilibrium is that the steady state must be a saddle point of the linearization of $E = 0$. A necessary and sufficient condition for this is:⁴

$$\|(E_2)^{-1}E_1 + (E_2)^{-1}E_3\| < 1$$

which is weaker than assumption **D**.

A basic example of this structure is the dynamic programming problem. Following the notation of Stokey and Lucas with Prescott (1989),

$$E(x_{t-1}, x_t, x_{t+1}) = F_2(x_{t-1}, x_t) + \beta F_1(x_t, x_{t+1})$$

where F is the return function, β is the discount factor and the set D is defined from technological constraints. In this case g represents the policy function. It is easy to verify that for the one-dimensional case, assumption **D (i)** amounts to the dominant diagonal condition of the Jacobian of E at the steady state.

3. Main Result

In this section we will provide an iterative method for computing stationary solutions in a neighborhood of a steady state for the model (X, D, E) . This method consists in defining an implicit map from the temporary equilibrium equation and showing that this map is a contraction with the stationary solution as the fixed point.

Given $r > 0$, $\gamma > 0$ and $\bar{x} \in \mathfrak{R}^n$ let us denote

$$\mathcal{H} = \{h \in C^2(B_r(\bar{x})); h(\bar{x}) = \bar{x}, \|Dh(x)\| \leq \alpha \text{ and } \|D^2h(x)\| \leq \gamma, \forall x \in B_r(\bar{x})\}$$

where $C^l(B_r(\bar{x}))$ is the space of l -th continuously differentiable functions from $B_r(\bar{x})$ into itself and γ is a constant.

Define the norm

$$\|h\|_1 = \sup_{x \in B_r(\bar{x})} \|Dh(x)\|, \text{ for all } h \in \mathcal{H}.$$

Let $\bar{\mathcal{H}}$ be the closure of \mathcal{H} with respect to this norm. Therefore, $(\bar{\mathcal{H}}, \|\cdot\|_1)$ is a complete metric space. Observe that, by the definition of the metric (uniform convergence in the first derivative), it is easy to see that $\bar{\mathcal{H}}$ is a subset of $C^1(B_r(\bar{x}))$.

³ The derivatives are evaluated at $(\bar{x}, \bar{x}, \bar{x})$. Observe that (i) implies (ii) when $n = 1$.

⁴ The quadratic equation $x^2 + ax + b = 0$ has a root with modulus greater than one and the other lower than one if and only if $|a| > |1 + b|$.

Lemma 3.1. Under **D**, there exist $r > 0$, $\gamma > 0$ and $\varphi : \mathcal{H} \rightarrow \mathcal{H}$ such that

$$E(x, \varphi_h(x), h^2(x)) = 0 \quad (*)$$

for all $x \in B_r(\bar{x})$ and $h \in \mathcal{H}$.

Theorem 3.2. Assume **D**. Then there exist $r > 0$ and $\gamma > 0$ such that $\varphi : \mathcal{H} \rightarrow \mathcal{H}$ defined in Lemma 3.1 is a η -contraction, for some $\eta \in (0, 1)$.

The proof of Theorem 3.2 shows that the map $\varphi : \bar{\mathcal{H}} \rightarrow \bar{\mathcal{H}}$ is a η -contraction and consequently has a fixed point. It is easy to see that such a fixed point is a stationary solution of (X, D, E) . Therefore, the map φ provides a recursive method for computing this solution in a neighborhood of the steady state.

The following corollary shows that the recursive method obtained from Theorem 3.2 holds in every neighborhood where assumption **D** is satisfied.

Corollary 3.3. If the assumption **D** is satisfied in a convex neighborhood \mathcal{N} of \bar{x} , then there exist $\gamma > 0$ and $\varphi : \mathcal{H} \rightarrow \mathcal{H}$ satisfying $(*)$ (where $B_r(\bar{x})$ is replaced by \mathcal{N}) and there exist $N \geq 1$ and $\eta < 1$ such that φ^N is a η -contraction with fixed point g .

4. The Algorithm and Numerical Examples

In this section we will describe the algorithm derived from Theorem 3.2. But first we will discuss other methods in the literature.

Let us consider the dynamic programming problem. The first method consists in defining the following operator from the Euler equation: given a feasible map $h : X \rightarrow X$, let us define $Th : X \rightarrow X$ implicitly by

$$F_2(x, Th(x)) + \beta F_1(Th(x), h(Th(x))) = 0.$$

The optimal policy function g is a fixed point of T and the sequence $(T^n(h_0))_n$ converges to g pointwise, where h_0 is constant.⁵ Indeed, we claim that this approach is equivalent to Bellman's method. To see this, define the following sequence of functions:

$$v_n(x) = \max_{\{y; (x,y) \in A\}} F(x, y) + \beta v_{n-1}(y)$$

for all $n \geq 1$, where A is the feasible set related with the problem and $v_0(x) = F(x, h_0(x))$. From the first order condition and the Envelope Theorem:

$$F_2(x, h_n(x)) + \beta F_1(h_n(x), h_{n-1}(h_n(x))) = 0,$$

⁵A constant function may not be feasible. In this case we have to choose, for instance, a piecewise constant h_0 .

where $h_n(x) = \underset{\{y; (x,y) \in A\}}{\operatorname{argmax}} F(x, y) + \beta v_{n-1}(y)$. Using the definition of T and this last equation, it is easy to see that $h_n = T^n(h_0)$. Hence, the Bellman method implies that h_n converges to g . In particular, this method is equivalent to Bellman's one.

Baxter *et al.* (1990)) implements that method making a discretization of the state space, whereas Coleman (1990, 1991) used a linear interpolation in each step.

Li (1998) uses a similar method to ours: she defines the same mapping φ of Theorem 3.2 and proves that it is a contraction in the C^0 topology. In Example 2 below we show that our approach has the following advantages: (i) the set of economies where the contractive property holds is larger than hers; (ii) the convergence is in the C^1 topology and, in particular, the stationary solution is C^1 .

The Algorithm

We now describe the main steps of the algorithm which implements our contractive method.⁶ The main difference of our implementation with respect to the methods above is that it is not necessary to make a discretization of the state space. More precisely, we can give an accurate approximation of the stationary solution for each $x \in X$.

Let $h_0 : X \rightarrow X$ be a constant function (for instance, $h_0 \equiv \bar{x}$, the steady state). Fix $x \in X$.

computing h_1 : solve

$$E(x, y, h_0^2(x)) = 0.$$

computing $h_2(x)$

first step: find $h_1^2(x)$, i.e., solve

$$E(h_1(x), y, h_0^2(h_1(x))) = 0.$$

second step: solve

$$E(x, y, h_1^2(x)) = 0$$

for finding $h_2(x)$.

In general, we have to proceed as follows:

computing $h_{n+1}(x)$

first step: find h_n^2 . In order to do this, we have to compute, using the equilibrium equation, the following sequence

$$h_1 h_n, h_1^2 h_n, h_2 h_n, h_1 h_2 h_n, h_1^2 h_2 h_n, h_2^2 h_n, h_3 h_n, \dots, h_{n-1}^2 h_n, h_n^2$$

where x was dropped in the notation.

⁶For the examples, we used MATLAB to implement the numerical routines. Upon request, we will provide the MATLAB code by E-mail. The E-mail address is humberto@fgv.br.

second step: solve

$$E(x, y, h_n^2(x)) = 0$$

for finding $h_{n+1}(x)$.

Therefore, as we can see the algorithm can compute $h_n(x)$ from solely $h_{n-1}(x)$ for each $x \in X$ without making any discretization of the state space in previous steps.

The Examples

1. Deterministic Growth Model

Consider the classical deterministic growth model with utility and production functions:

$$u(c) = \frac{c^{1-\gamma}}{1-\gamma} \text{ and } f(k) = Ak^\alpha$$

where $\gamma \geq 0$ (for $\gamma = 1$, $u(c) = \ln c$) and $0 < \alpha \leq 1$.

The Euler equation is given by:

$$E(x, y, z) = -(x^\alpha - y)^{-\gamma} + \beta \alpha y^{\alpha-1} (y^\alpha - z)^{-\gamma} = 0.$$

For $\alpha = 1$ and $\gamma = 1$ it is possible to determine the operator φ explicitly

$$\varphi_h(k) = \frac{h^2(k) + \beta k}{1 + \beta}$$

and the optimal policy function $g(k) = \beta k^\alpha$ which is a fixed point of φ . It is important to note that these explicit calculations are not possible for the remaining cases below and, therefore, this justifies the use of the proposed algorithm.

Using the Mean Value Theorem, we have the following estimative:

$$\|\varphi_{h_1} - \varphi_{h_2}\| \leq \frac{1 + \|Dh_1\|}{1 + \beta} \|h_1 - h_2\|,$$

where $\|\cdot\|$ is the sup norm. Taking the domain of φ as $h_1 \in C^1$ such that $\|Dh\| \leq M < \beta$ it results that φ is a contraction. It is important to note our theorem guarantees a C^1 -contraction probably in a smaller domain.

In figures 1 and 2 we show the numerical results of our method in two particular specification of the parameters: $\beta = .95$ and domain $[\bar{k}; 1]$. The initial function is $h_0(k) = \min \{\bar{k}, k\}$.

In figure 1, $u(c) = \ln(c)$, $\alpha = .34$ and the optimal policy function is the continuous line and the iterations h_1 and h_{10} (which is close to g) are the dotted lines (the distance between h_9 and h_{10} is 1.349×10^{-7}). In figure 2, if $\gamma = .2$ and $\alpha = .5$, then the true optimal policy is not explicitly known and we only show the iterations h_1 through h_9 in dotted line and h_{10} in continuous line (the distance between h_{10} and g is 1.087×10^{-9}).

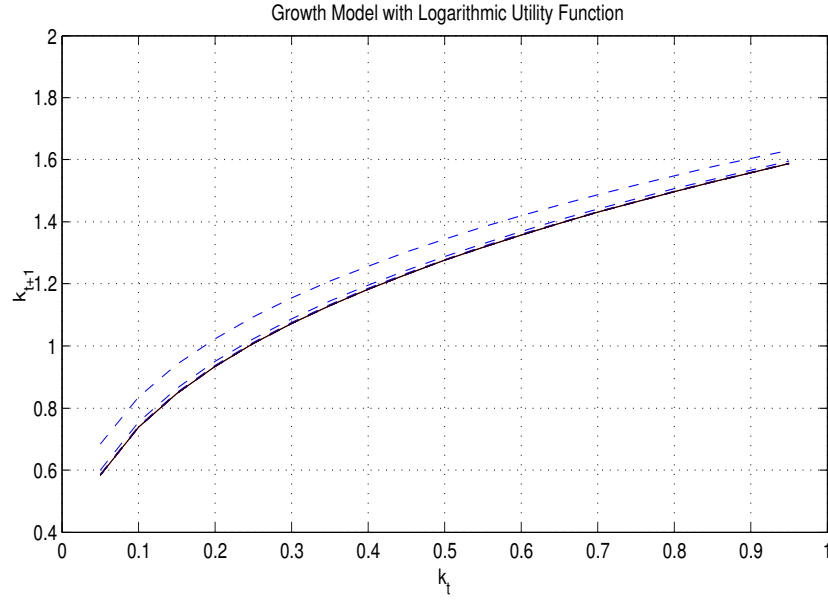


FIGURE 1: Deterministic growth model with $u(c) = \ln c$, $A = 5$, $\alpha = .34$, $\beta = .95$ and iterations= 10.

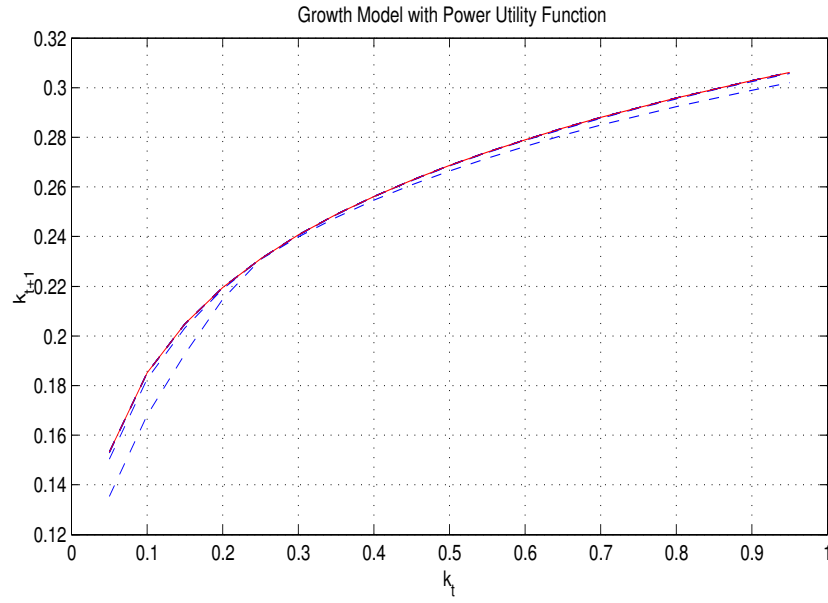


FIGURE 2: Deterministic growth model with $\gamma = .2$, $A = 5$, $\alpha = .5$, $\beta = .95$ and iterations= 10.

2. A Monetary Model (Li (1998))

Li (1998) presents a monetary model with preferences given by $U(c) = c^{1-A}/(1-A)$ ($A \geq 0$ and $A \neq 1$) and discount factor $0 < \beta < 1$. The intertemporal equilibrium equation for this model is given by:

$$E(p_{t-1}, p_t, p_{t+1}) = p_t + \phi\left(\frac{p_t}{p_{t+1}}\right)p_{t-1} - 1 = 0$$

where p_t is the (scaled) price of the economy in period t and $\phi(x) = \frac{\beta^{1/A}}{\beta^{1/A} + x^{(A-1)/A}}$.

A stationary solution is defined by a function $g : [0, 1] \rightarrow [0, 1]$ such that

$$1 - x\phi\left(\frac{g(x)}{g \circ g(x)}\right) = g(x),$$

which gives a steady state equilibrium value: $\bar{p} = 1/(1 + \phi(1))$.

Our assumption **D** imposes the following bounds for the parameter values:

$$\begin{cases} 0 < \phi(1) < 1 - 2|\phi'(1)| & \text{if } \phi'(1) \in (-1, 0) \\ 0 < \phi(1) < 1 & \text{if } \phi'(1) \geq 0. \end{cases}$$

Thus, the required parameter value set in Li (1998) are strictly included in ours, as one can easily check. Moreover, the convergence is in the C^1 -topology (instead of the C^0 -convergence found by Li (1998)).

Figure 3 shows stationary solution approximations for the following parameter values: $A = .4$ and $\beta = .99$ and the interval of price is $[.05; 1]$. We made ten interactions where the continuous line represents the tenth one (the distance from the ninth is 1.361×10^{-8}).

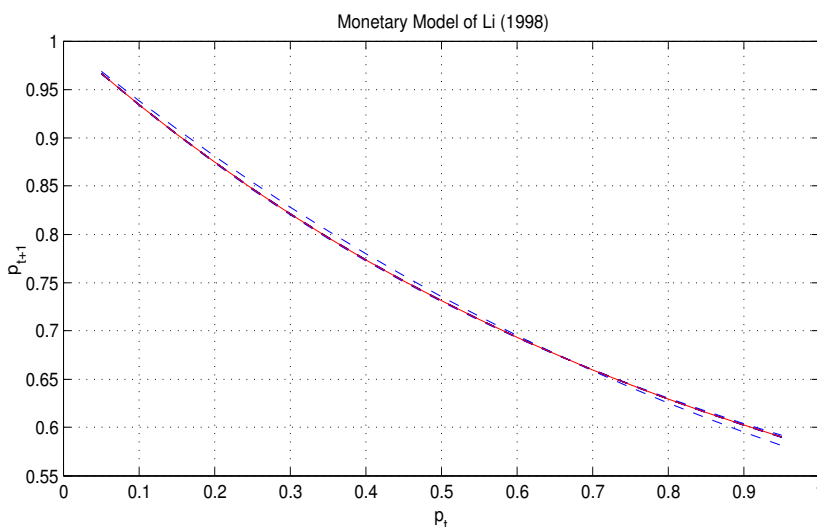


FIGURE 3: Stationary solution of the monetary model of Li (1998) with $A = .4$, $\beta = .99$ and iterations= 10.

3. Growth with Externalities Model (Boldrin and Rustichini (1994))

Boldrin and Rustichini (1994) analyzes a two-sector growth model with labor externality. The utility function is linear and the technological frontier is characterized by:

$$T(x, x', k) = (k^\eta - x')^\alpha (x - \gamma x')^{1-\alpha}$$

where x is the current capital value, x' is the next period capital value, k is the current aggregate capital stock which is considered as an externality in the total number of units of labor and $\alpha, \gamma \in (0, 1)$. In this case the intertemporal equilibrium equation is given by:

$$E(x_t, x_{t+1}, x_{t+2}) = T_2(x_t, x_{t+1}, x_t) + \beta T_1(x_{t+1}, x_{t+2}, x_{t+1}) = 0$$

and the unique interior steady state is

$$\bar{x} = \left(\frac{(\beta - \gamma)(1 - \alpha)}{(\beta - \gamma)(1 - \alpha) + (1 - \gamma)\alpha} \right)^{1/(1-\eta)}.$$

In this model, condition D is:

$$|T_{22} + \beta(T_{11} + T_{13})| > \beta|T_{12}| + |T_{12} + T_{23}|$$

which is stronger than the condition for the existence of a saddle steady state (see the remark after assumption **D**).

Figure 4 shows the approximations of the stationary solution around the steady state for parameter values that satisfy assumption **D**. The parameters are: $\alpha = .5$, $\beta = .95$, $\gamma = .5$, $\eta = .5$ and the interval of capital is $[.05; 1]$. We did ten interactions where the continuous line represents the tenth one (the distance from the ninth is 2.233×10^{-7}).

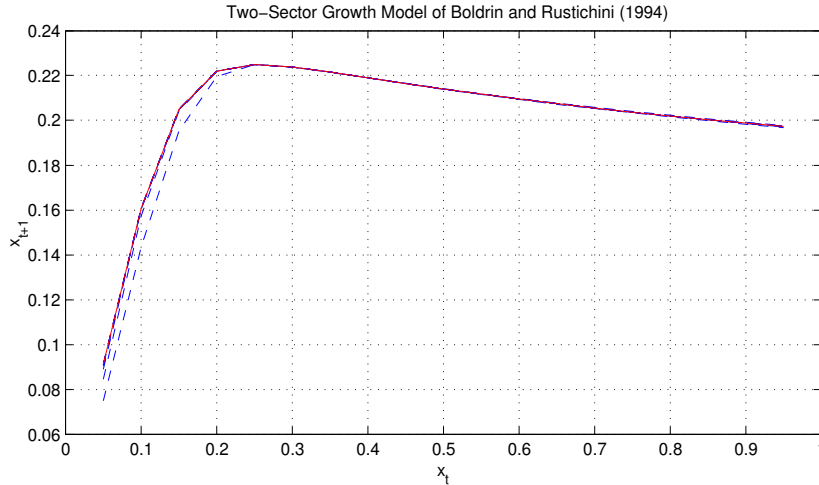


FIGURE 4: Stationary solution of the two-sector growth model of Boldrin and Rustichini (1994) with $\alpha = \eta = \gamma = .5$, $\beta = .95$ and iterations= 10.

5. Conclusions

In this paper we provide a recursive method to approximate the stationary solution of the Euler equation for intertemporal deterministic models. Its major difference from classical methods is that it is performed from a contraction mapping in the C^1 -topology of a suitable functional space. In particular this implies the continuous differentiability of the stationary solution.

The required hypothesis is an open condition related with the first derivatives of the structural equations evaluated at the steady state. This hypothesis is slightly stronger than the determinacy of the steady state condition.

Another interesting feature of this method is that the algorithm that implements it needs neither a discretization of the state space nor a piecewise linear approximations of the iterations. Our algorithm is illustrated by numerical examples applied to some models in the literature.

APPENDIX

Proof of Lemma 3.1: Assumption **D** implies that there exists $r > 0$ such that $B_r(\bar{x}, \bar{x}, \bar{x}) \subset D$ and

$$\sup_{B_r(\bar{x}, \bar{x}, \bar{x})} \|E_2^{-1}E_1\| + \|E_2^{-1}E_3\| < \alpha \quad (I)$$

and

$$\sup_{B_r(\bar{x}, \bar{x}, \bar{x})} \|E_2^{-1}E_3\| < 1/2. \quad (II)$$

Let $h \in \mathcal{H}$ and observe that the function $(x_1, x_2) \mapsto E(x_1, x_2, h^2(x_1))$ defined on a neighborhood of (\bar{x}, \bar{x}) is twice continuously differentiable,

$$E(\bar{x}, \bar{x}, h^2(\bar{x})) = E(\bar{x}, \bar{x}, \bar{x}) = 0$$

and $E_2(x_1, x_2, h^2(x_1))$ is a negative definite matrix for all (x_1, x_2) in a neighborhood of (\bar{x}, \bar{x}) . By the Implicit Function Theorem, there exist $\epsilon_1, \epsilon_2 \in (0, r)$ and a continuously differentiable function $\varphi : B_{\epsilon_1}(\bar{x}) \rightarrow B_{\epsilon_2}(\bar{x})$ ($\varphi = \varphi_h$) such that

$$E(x_1, x_2, h^2(x_1)) = 0, \quad x_i \in B_{\epsilon_i}(\bar{x}), \quad i = 1, 2 \iff x_2 = \varphi(x_1).$$

Moreover, for each x in $B_{\epsilon_1}(\bar{x})$,

$$\begin{aligned} D\varphi(x) &= -E_2^{-1}(x, \varphi(x), h^2(x)) [E_1(x, \varphi(x), h^2(x)) + E_3(x, \varphi(x), h^2(x)) Dh(h(x)) Dh(x)] \\ &\Rightarrow \|D\varphi(x)\| \leq \sup_{B_r(\bar{x}, \bar{x}, \bar{x})} \|E_2^{-1}E_1\| + \|E_2^{-1}E_3\| < \alpha, \quad \text{for all } x \in B_{\epsilon_1}(\bar{x}) \end{aligned}$$

because of (I) and the fact that $\|Dh(x)\| \leq \alpha < 1$ on $B_r(\bar{x})$.

Observe that

$$\varphi(x) = \bar{x} + \int_0^1 D\varphi(\bar{x} + t(x - \bar{x}))(x - \bar{x}) dt, \quad \text{for all } x \in B_{\epsilon_1}(\bar{x})$$

$$\Rightarrow |\varphi(x) - \bar{x}| \leq \sup_{t \in [0,1]} \|D\varphi(\bar{x} + t(x - \bar{x}))\| |x - \bar{x}| < \epsilon_1$$

and, therefore, we can suppose that $\epsilon = \epsilon_1 = \epsilon_2$.

We claim that we can take $\epsilon = r$. Let $r^* = \sup \{\epsilon > 0; \varphi \text{ is defined on } B_\epsilon(\bar{x})\}$. Suppose that $r^* < r$. First, for each $x_1 \in B_{r^*}(\bar{x})$, there exists a unique $x_2 \in B_{r^*}(\bar{x})$ such that $E(x_1, x_2, h^2(x_1)) = 0$. Otherwise, there exist x_2 and \tilde{x}_2 , $x_2 \neq \tilde{x}_2$, satisfying the last equality. Define $f: [0, 1] \rightarrow \mathfrak{R}$ by

$$f(t) = (x_2 - \tilde{x}_2)' E(x_1, x_2 + t(x_2 - \tilde{x}_2), h^2(x_1)).$$

Then $f(0) = f(1) = 0$ and $f'(t) = (\tilde{x}_2 - x_2)' E_2(x_2 - \tilde{x}_2) < 0$. Since E_2 (calculated at $(x_1, x_2 + t(x_2 - \tilde{x}_2), h^2(x_1))$) is a negative definite matrix, this is a contradiction.

Let x be a point on the border of $B_{r^*}(\bar{x})$. Let $(x_n)_{n \geq 0}$ be a sequence in $B_{r^*}(\bar{x})$ converging to x . Since $(\varphi(x_n))_{n \geq 0}$ is a sequence in $B_{r^*}(\bar{x})$ (a compact set), there exists a subsequence converging to a point $y \in B_{r^*}(\bar{x})$. By the continuity of $E(\cdot, \cdot, h^2(\cdot))$, $E(x, y, h^2(x)) = 0$. However, y is uniquely determined, implying that the sequence $(\varphi(x_n))_{n \geq 0}$ converges to y . We can apply again the Implicit Function Theorem at $(x, y, h^2(x))$ for the Euler equation. Doing this for all points on the border of $B_{r^*}(\bar{x})$, we can extend φ to a ball centered at \bar{x} which contains (strictly) $B_{r^*}(\bar{x})$. This contradicts the definition of r^* .

Now we choose the constant $\gamma > 0$. Let us calculate the second order derivative of φ :

$$\begin{aligned} D^2\varphi(x) = & - [D(E_2^{-1}E_1) + D(E_2^{-1}E_3)Dh(h(x))Dh(x)] \\ & - E_2^{-1}E_3[D^2h(h(x))(Dh(x))^2 + Dh(h(x))D^2h(x)] \end{aligned}$$

(calculated at $(x, \varphi(x), h^2(x))$). Taking the supremum on the right side and using (II) we have⁷

$$\|D^2\varphi(x)\| \leq c_1 + (\alpha^2\gamma + \alpha\gamma)\sup_{B_r(\bar{x}, \bar{x}, \bar{x})}\|E_2^{-1}E_3\| \leq c_1 + c_2\gamma$$

where $c_1 > 0$ and $0 < c_2 < 1$ (by (II)). Choose γ sufficiently large such that $c_1 + c_2\gamma \leq \gamma$.

Proof of Theorem 3.2: Let $\mathcal{B} \subset \mathcal{M}_n$ be the unit ball. Since E is C^2 , there exists $r > 0$ such that the map

$$\Psi : B_r(\bar{x}, \bar{x}, \bar{x}) \times \mathcal{B}^2 \rightarrow \mathcal{M}_n$$

defined by

$$\Psi(x_1, x_2, x_3, M_1, M_2) = -E_2^{-1}(x_1, x_2, x_3)[E_1(x_1, x_2, x_3) + E_3(x_1, x_2, x_3)M_1M_2]$$

is a Lipschitz function, i.e., there exists $L > 0$ such that:

$$\|\Psi(x^1, M^1) - \Psi(x^2, M^2)\| \leq L \sum_{i=1}^3 |x_i^1 - x_i^2| + S_r[\|M_1^1 - M_1^2\| + \|M_2^1 - M_2^2\|] \quad (III)$$

⁷Observe that one of the components of the derivative of $E_2^{-1}E_1$ and $E_2^{-1}E_3$ involves the derivatives of φ and h which are uniformly bounded by α .

where we are denoting $x^i = (x_1^i, x_2^i, x_3^i) \in B_r(\bar{x})^3$, $M^i = (M_1^i, M_2^i) \in \mathcal{B}^2$, $i = 1, 2$ and $S_r = \sup_{B_r(\bar{x}, \bar{x}, \bar{x})} \|E_2^{-1} E_3\|$.

The fact that E is C^1 and assumption **D** (ii) guarantee that we can choose $r > 0$ such that $S_r < 1/2$. Finally, we choose such r satisfying Lemma 3.1 and:

$$\frac{(Lr\alpha + S_r)(2 + \gamma r)}{1 - Lr} = \eta_r < 1$$

(notice that $|\eta_r - 2S_r| \rightarrow 0$ when $r \rightarrow 0$).

We will prove that the function $\varphi: \mathcal{H} \rightarrow \mathcal{H}$ defined by $\varphi(h) = \varphi_h$ is a η_r -contraction mapping (φ_h defined in Lemma 3.1).

Given $h_1, h_2 \in \mathcal{H}$, by Lemma 3.1, for $i = 1, 2$ and $x \in B_r(\bar{x})$,

$$D\varphi_{h_i}(x) = \Psi(x, \varphi_{h_i}(x), h_i^2(x), Dh_i(h_i(x)), Dh_i(x))$$

Observe that

$$Dh_i^2 = Dh_i(h_i)Dh_i, \quad i = 1, 2$$

and

$$\begin{aligned} Dh_1(h_1)Dh_1 - Dh_2(h_2)Dh_2 &= (Dh_1(h_1) - Dh_2(h_1))Dh_1 \\ &\quad + (Dh_2(h_1) - Dh_2(h_2))Dh_1 + Dh_2(h_2)(Dh_1 - Dh_2). \end{aligned}$$

Thus,

$$\|h_1^2 - h_2^2\|_1 \leq \alpha\|h_1 - h_2\|_1 + \alpha\gamma r\|h_1 - h_2\|_1 + \alpha\|h_1 - h_2\|_1 \quad (\text{IV})$$

by the definition of $\|\cdot\|_1$ and the space \mathcal{H} .

Therefore, from (III) and (IV)

$$\begin{aligned} \|\varphi_{h_1} - \varphi_{h_2}\|_1 &\leq L(r\|\varphi_{h_1} - \varphi_{h_2}\|_1 + r\alpha(2 + \gamma r)\|h_1 - h_2\|_1) + (2 + \gamma r)S_r\|h_1 - h_2\|_1 \\ \Rightarrow \|\varphi_{h_1} - \varphi_{h_2}\|_1 &\leq \eta_r\|h_1 - h_2\|_1. \end{aligned}$$

So $\varphi: \mathcal{H} \rightarrow \mathcal{H}$ is a η_r -contraction. It is easy to see that we can extend continuously φ to $\bar{\mathcal{H}}$. Let φ also denote this extension, then we obtain a η_r -contraction on \bar{D}_r . By the Banach Fixed Point Theorem, there exists $g \in \bar{D}_r$ such that $\varphi_g = g$ and

$$\|\varphi^n(h) - g\|_1 \leq (\eta_r)^n\|h - g\|_1, \quad \text{for all } h \in D_r.$$

Proof of Corollary 3.3: Fix $r > 0$ and let $\rho > 0$ be such that $\alpha(r + \rho) \leq r$ (i.e. $\rho \leq \frac{1-\alpha}{\alpha}r$) and assumption **D** holds in $B_{r+\rho}(\bar{x}) \cap C$. From assumption **D**(i), the choice of ρ guarantees that for each $h \in \bar{D}_{r+\rho}$, $h(x) \in B_r(\bar{x})$ for all $x \in B_{r+\rho}(\bar{x})$. Let $B = B_r(\bar{x})$, $A = B_{r+\rho}(\bar{x}) - B$ and $|\cdot|_i^A, |\cdot|_i^B$ the C^i -norm for $i = 0, 1$ on A and B , respectively. For $h_1, h_2 \in D_{r+\rho}(\bar{x})$ we have:

$$|\varphi_{h_1} - \varphi_{h_2}|_1^A \leq L\{\rho|\varphi_{h_1} - \varphi_{h_2}|_1^A + |\varphi_{h_1} - \varphi_{h_2}|_0^B + \rho|h_1^2 - h_2^2|_1^A + |h_1^2 - h_2^2|_0^B\} \\ + S_{r+\rho}[\gamma|h_1 - h_2|_0^A + |h_1 - h_2|_1^B] + S_{r+\rho}\gamma|h_1 - h_2|_1^A$$

From definitions of $|\cdot|_i^A$ and $|\cdot|_i^B$ we have the following inequalities:

$$|h_1^2 - h_2^2|_1^A \leq \alpha|h_1 - h_2|_1^B + \alpha\gamma[\rho|h_1 - h_2|_1^A + |h_1 - h_2|_0^B] + \alpha|h_1 - h_2|_1^A; \\ |h_1^2 - h_2^2|_0^B \leq r(\alpha + 1)|h_1 - h_2|_1^B; |h_1 - h_2|_0^A \leq |h_1 - h_2|_0^B + \rho|h_1 - h_2|_1^A; \\ |\varphi_{h_1} - \varphi_{h_2}|_0^B \leq r|\varphi_{h_1} - \varphi_{h_2}|_1^B \leq r\eta_r|h_1 - h_2|_1^B.$$

Using these last three inequalities in the first one we get:

$$(1 - L\rho)|\varphi_{h_1} - \varphi_{h_2}|_1^A \leq [L\alpha\rho + S_{r+\rho}](1 + \gamma\rho)|h_1 - h_2|_1^A \\ + [L\alpha\rho(1 + \gamma) + Lr(\eta_r + \alpha + 1) + S_{r+\rho}(r\gamma + 1)]|h_1 - h_2|_1^B.$$

Defining

$$\begin{cases} \alpha_\rho = [L\alpha\rho + S_{r+\rho}](1 + \gamma\rho)(1 - L\rho)^{-1} \\ \gamma_\rho = [L\alpha\rho(1 + \gamma) + Lr(\eta_r + \alpha + 1) + S_{r+\rho}(r\gamma + 1)](1 - L\rho)^{-1} \end{cases}$$

we have that

$$|\varphi_{h_1} - \varphi_{h_2}|_1^A \leq \alpha_\rho|h_1 - h_2|_1^A + \gamma_\rho|h_1 - h_2|_1^B.$$

By induction

$$|\varphi_{h_1} - \varphi_{h_2}|_1^A \leq \alpha_\rho^n|h_1 - h_2|_1^A + \gamma_\rho \left(\sum_{i=0}^{n-1} \alpha_\rho^{n-1-i} \eta_\rho^i \right) |h_1 - h_2|_1^B \leq \gamma_n |h_1 - h_2|_1^{A \cup B}.$$

where

$$\gamma_n = \text{Max}\{\alpha_\rho^n, n\gamma_\rho(\text{Max}\{\alpha_\rho, \eta_\rho\})^{n-1}\}.$$

Since $\alpha_\rho \rightarrow S_r < 1/2$ when $\rho \rightarrow 0$ and $\eta_r < 1$ then, for all $\rho > 0$ small enough, we can find $n > 1$ such that $\gamma_n < 1$, so φ^n is a γ_n -contraction.

REFERENCES

- Baxter, M., M. J. Crucini and K. G. Rouwenhorst (1990)**, “Solving the Stochastic Growth Model by a Discrete-State-Space, Euler-Equation Approach”, *Journal of Business & Economic Statistics*, 8, 19-21.
- Boldrin, M. and A. Rustichini (1994)**, “Growth and Interminancy Models with Externalities”, *Econometrica*, 62 (2), 323-42.

Christiano, L. J. (1990), “Solving the stochastic growth model by linear-quadratic approximation and by value function iteration”, *Journal of Business and Economic Statistics*, 8, 23-26.

Coleman, W. J. (1990), “Solving the Stochastic Growth Model by Policy-Function Iteration”, *Journal of Business & Economic Statistics*, 8, 27-29.

Coleman, W. J. (1991), “Equilibrium in a Production Economy with an Income Tax”, *Econometrica*, 59, 1091-1104.

Judd, K. L. (1992), “Projection Methods for Solving Aggregate Growth Models”, *Journal of Economic Theory*, 58, 410-52.

Judd, K. L. (1998), “Numerical Methods in Economics”, The MIT Press, Cambridge, Massachusetts.

Li, X. J. (1998), “Numerical Analysis of a Nonlinear Operator Equation Arising from a Monetary Model”, *Journal of Economic Dynamics and Control*, 22, 1335-51.

Maldonado, W. and B. Svaiter (2001), “On the accuracy of the estimated policy function using the Bellman contraction method”, *Economics Bulletin*, Vol. 3, No. 15, 1-8.

Marcet, A. (1988), “Solving non-linear stochastic models by parameterized expectations”, Working Paper, Carnegie Mellon University.

Marcet, A. and G. Lorenzoni (1998), “Parameterized Expectations Approach; Some practical issues”, working paper.

Santos, M. S. and J. Vigo-Aguiar (1998), “Analysis of a Numerical Dynamic Programming Algorithm Applied to Economic Models”, *Econometrica*, 66, 409-26.

Stokey, N. L. and R. E. Lucas (with E. Prescott) (1989), “Recursive Methods in Economic Dynamics”, Harvard University Press, Cambridge, Mass. and London.

Taylor, J. B. and H. Uhlig (1990), “Solving Nonlinear Stochastic Growth Models: A Comparison of Alternative Solution Methods”, *Journal of Business & Economic Statistics*, 8, 1-17.